

# ARIF symposium

## Private Equity Direct Investments

### Elements for a successful Due Diligence

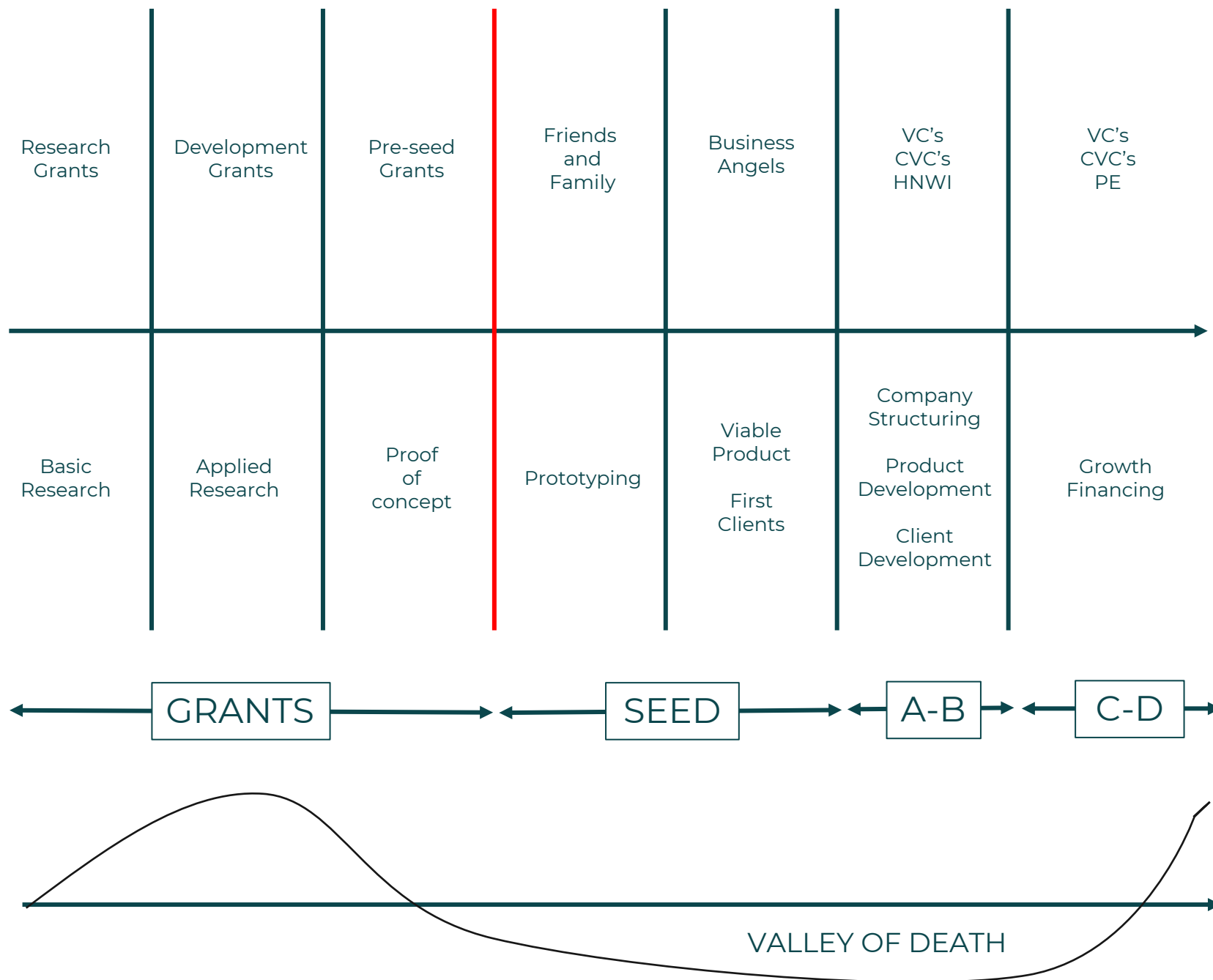
# **Direct Investments**

## The Ecosystem

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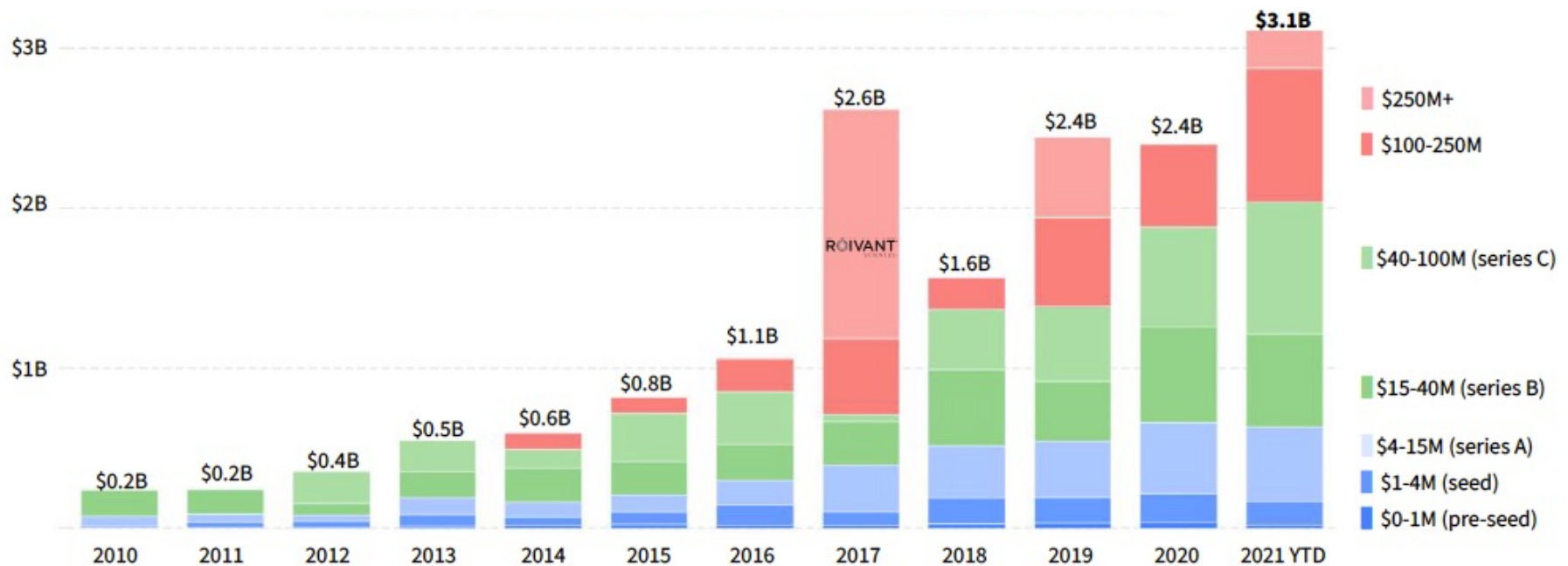
# VC Investment Stages





# The Swiss VC Investment Landscape

## Venture Capital Investments into Swiss startups by stage

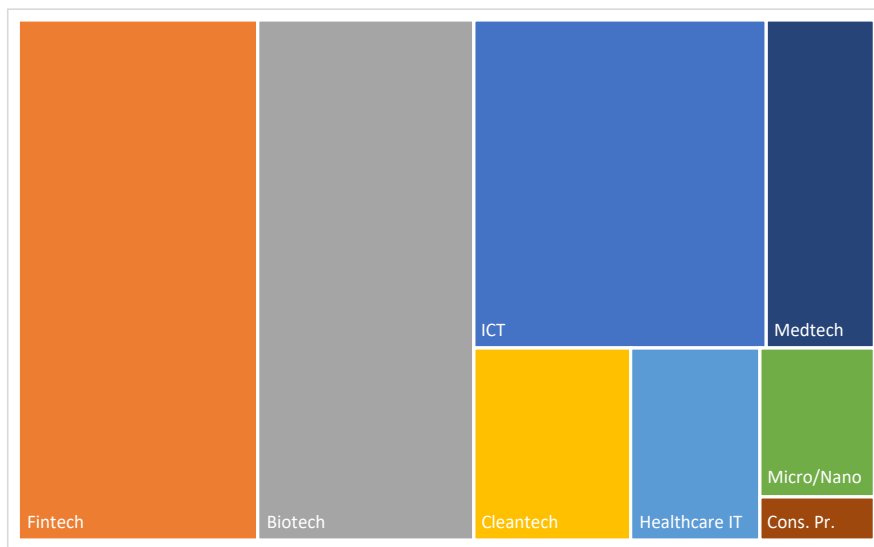


50% of investments since 2015 in Health Tech

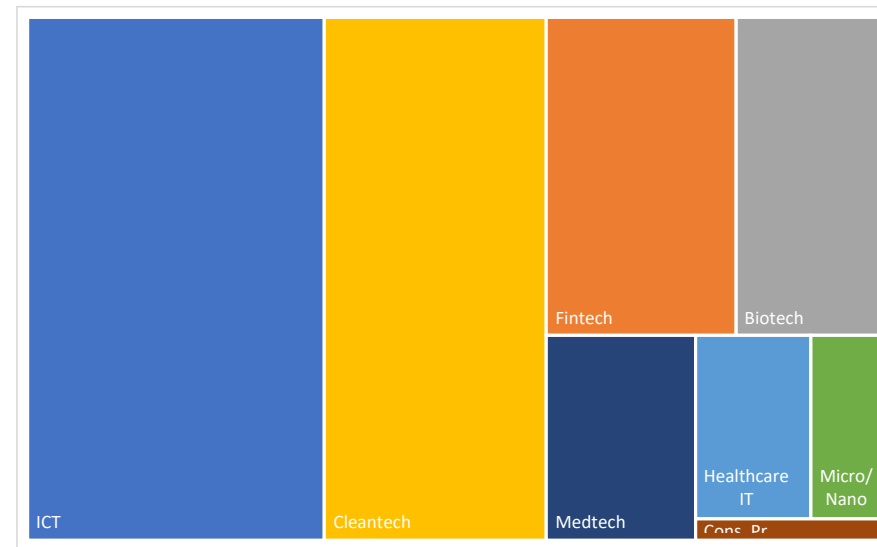
# The Swiss VC Investment Landscape

Amounts invested by sector

2021  
CHF 3'059 m

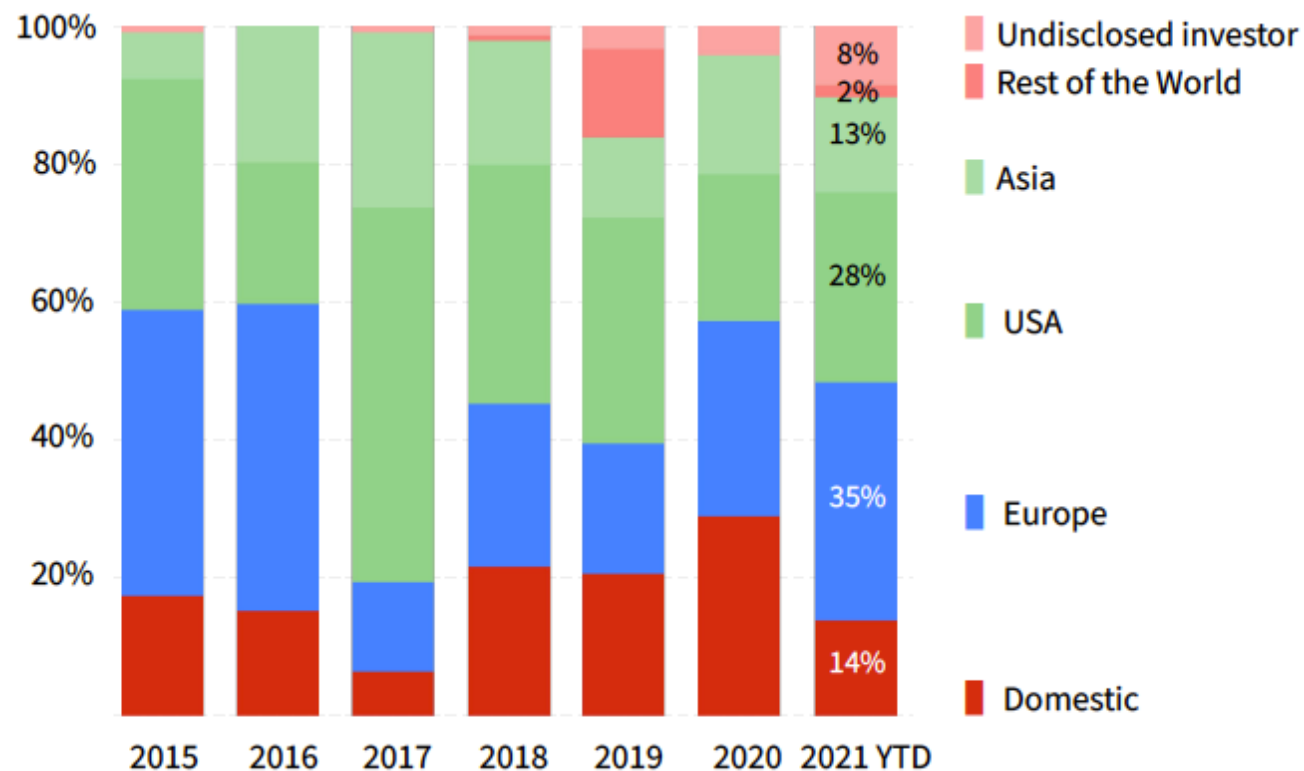


2022 H1  
CHF 2'586 m



# The Swiss VC Investment Landscape

## Swiss Venture Capital Investments by source



86% of investments came from abroad



# **Direct Investments**

## Challenges and opportunities

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# Why Direct Deals ?

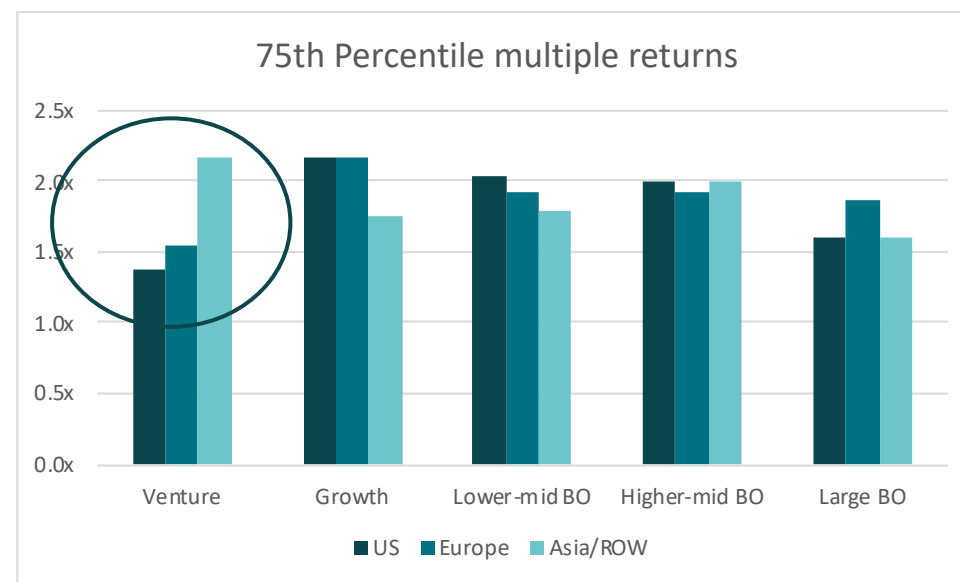
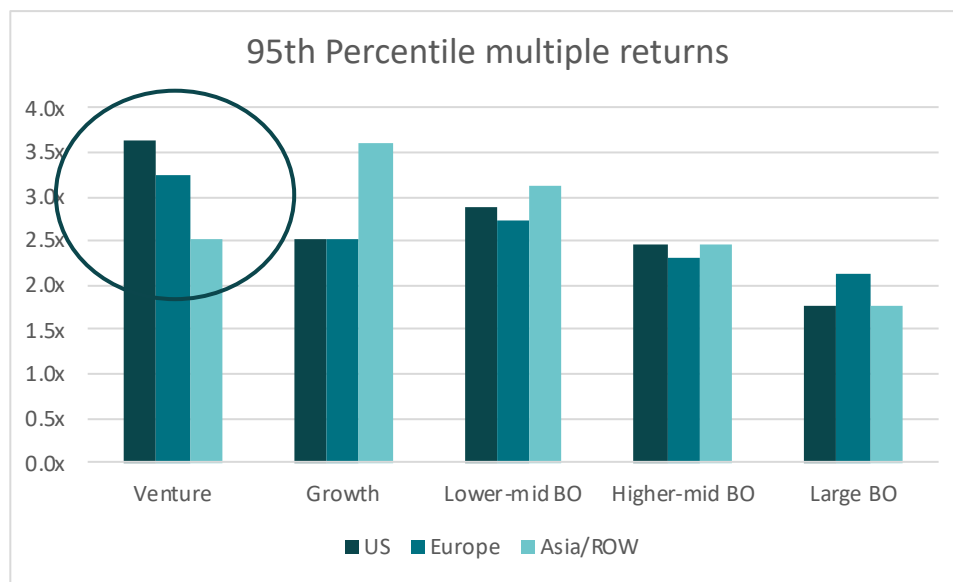
Amongst the motivations for direct investing, we find:

- Save on intermediaries' fees
- Disappointing returns from funds and high levels dry-powder
- **Capitalizing on client's domain expertise**
- Career opportunities for the next generation
- **Concentrating into high-conviction investments**
- Better alignment with family values (ESG / SRI factors)
- Greater control and transparency over investments
- Ability to time entry and exit points for the investment
- Enhanced ability to customize risk exposure
- **Peer influence and personal visibility**



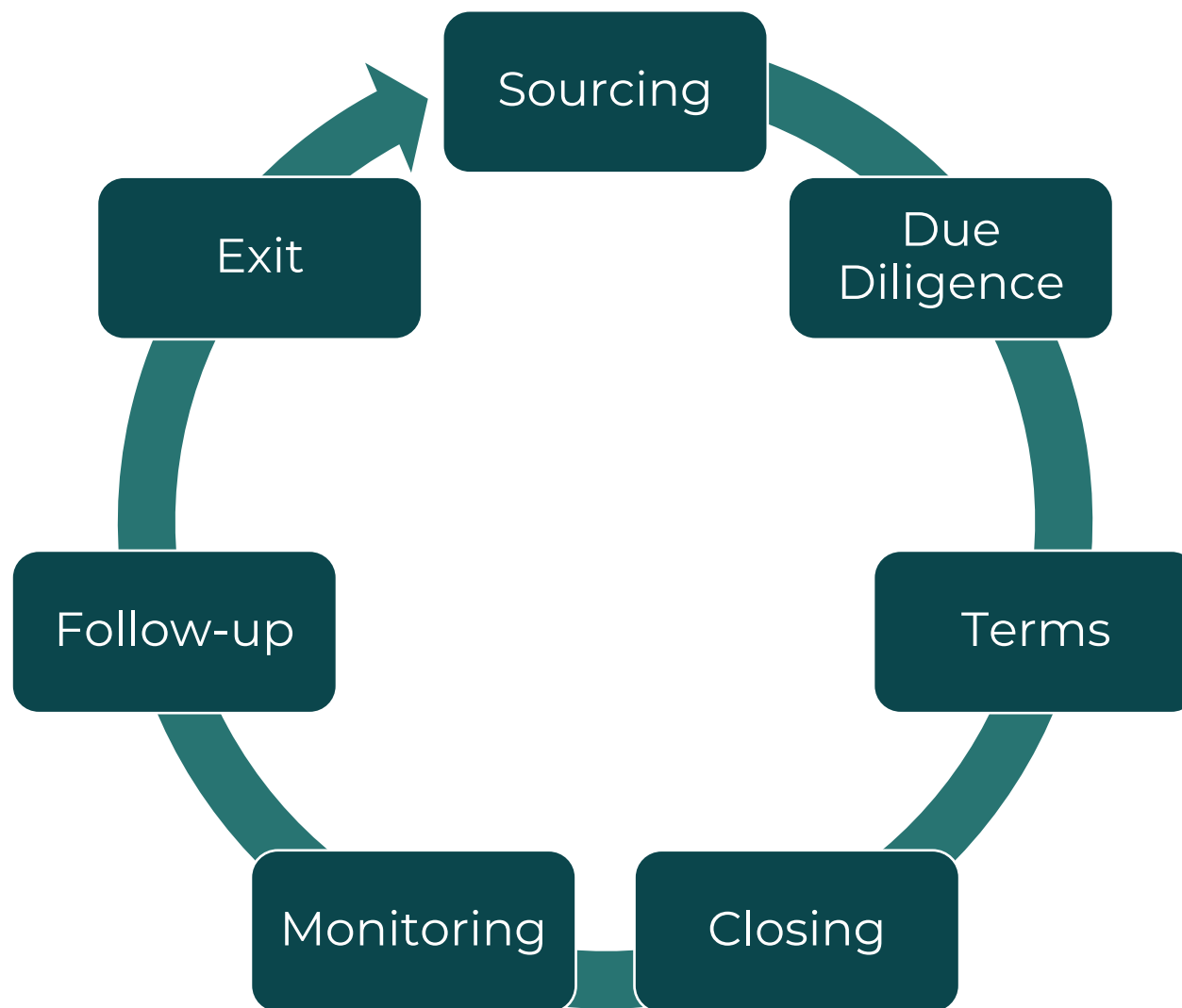
# PE and VC funds multiples

Average Peer Group Multiples 1997 - 2017



Source: Burgiss data 1997-2017 sample of 1789 funds

# Direct investment cycle



# Skills and Resources Required

Resources depend on the level of implication from the future investor:

- **Direct "solo" vs. co-investment / club deals**
- **Lead vs. follower**
- **Active vs. passive** (board membership, active implication)

In general skills required are:

- **Sourcing**
- **Domain Expertise**
- **Due Diligence and execution**
- **Operational follow-up and reporting**

Skills are expensive to onboard. Nevertheless, these can be partially or totally outsourced to reduce issues linked to "adverse-selection" and "blind-spots" as well as ensure best governance practices.



# **Direct Investments**

## Important Features

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# Pre-money vs Post-money

Always clarify which notion is used in discussions :

## Pre-money valuation

- Value of a company not including external the latest round of funding. It indicates how much a company might be worth before it begins to receive any investments. It gives investors an idea of the **current value of the business**.

*Pre-money valuation = current number of shares \* new price per share*

## Post-money valuation

- How much the company is worth after it receives the money and investments into it. Post-money valuation includes outside financing or the latest capital injection.

*Post-money valuation = pre-money valuation + new investment*



# Valuation Methods

Use 3 scenarios when valuing a company:

1. Best Case (Management Expectations)
2. Base Case (Best Case \* 70%)
3. Worst Case (Best Case \* 50%)

Time horizon 5 years maximum

- Discounted Cash Flow (if possible)
- Comparable transactions
- Peer group multiples (P/Sales, P/EV, P/EBITDA)

Use probabilities

SCENARIO	DCF		COMPARABLE TRANSACTIONS		PEER GROUP MULTIPLES		PROB.	FINAL VALUE
	DCF Valuation	Weighted DCF	CT Valuation	Weighted Comp.	PG Valuation	Weighted Peer Grp.	P(x) %	
Best Case	120	60	150	75	170	85	50%	
Base Case	84	17	105	21	119	24	20%	
Worst Case	60	18	75	23	85	26	30%	
		94.8		118.5		134.3	100%	115.9



# Dilution

When investing in a company always keep funds earmarked for participating in following rounds and avoid dilution.

*Total investment = initial investment + follow-up investment(s)*

Dilution can be significant for fast growing companies and can lead to disappointment at exit.

Various factors behind dilution to consider:

- **Future financing rounds forecasted**
- **Convertible loans**
- **ESOP**
- **Anti-Dilution clauses** (Down Rounds)
- **Liquidation preferences**

# Investment vehicles

- Equity
  - Preferred vs. Common shares – Registered
  - Terms
- Debt
  - Subordination or not (725 co)
  - Non dilutive but beware of high interest rates
- Convertible Loan
  - Beware of terms and covenants
- SAFE - US / (ABSA AIR - France)
  - Quick way of getting financing without fixing valuation
  - Options are exercised at the following round with conditions
- Token
  - Beware of legal and tax implications
- Crowdfunding
  - Increase of visibility for the company

# Terms

- Documents:
  - **Term Sheet** / LOI - (Non-binding / Binding)
  - **Investment Agreement** (conditions of specific financing round)
  - **Shareholder Agreement** (framework betw. Company and shareh.)
  - **Loan contract**
- Most usual terms:
  - Founder Equity vesting period
  - Purchase Option (Good vs Bad leaver – 337 & 340 CO)
  - Liquidation Preference
  - Dividend Preference
  - **Right of first refusal**
  - **Tag-Along (right to sell along at same price of another investor)**
  - **Drag-Along (obligation to sell along)**
  - Anti-Dilution (protection against down-round)
  - Information Rights
  - Mandatory Conversion into Common Shares (IPO)
  - Share Sell-Back right
  - Clawback



# Board Membership

An investor in a private company may require a board seat or alternatively an observer seat. The main reasons for it are better information (beyond the ones allowed by the SHA) and operational involvement.

Important points to consider:

- **Personal liability** (eventually requiring a D&O insurance)
- **Conflicts of interest** preventing to act in the sole interest of the company
- **Expertise** brought to the company
- **Remuneration**
- **Time** consumption

	Startup	Revenue	Growth
Role of Board Member/Company Needs	Working/Active	Shaping/Nurturing	Governing/Monitoring
Customer Discovery and Market Development	High	Moderate	Low
Product Development	High	Moderate/High	Low
Sales and Marketing	High/Moderate	High	High
Finance and Operational controls	Moderate/Low	Moderate	High
Human Resources	Low	Moderate	High
Strategy	High	High	High

# Due Diligence Check List (Dataroom)

1. Company and Product Presentation
2. Statutory Documentation
3. Customers and Commercial Organization
4. Suppliers and Contractors
5. Organization and Human Resources
6. Logistics and Production
7. R&D, IP, Data Protection, Security
8. Financial Information
9. Business Plan and Current Financing
10. Environmental and Social Impact

# Preventing Fraud

- Beware of intermediaries – Check their references
- Check public databases
  - FINMA
  - ZEFIX
  - Consumer organizations warning lists
  - Google search
  - Google Map
- Usual Red Flags
  - Promise or **guarantee** of high returns
  - **Impossible to talk** to founder(s) or C level person
  - Lack of clear **geographical location** (founder / company)
  - No **verifiable references** or founders' CV
  - No client / investor / supplier **call** possible
  - **Unclear pitch deck** missing key elements
  - No or little **Dataroom** documentation (board minutes)
  - High **board member turnover**
  - **Pressure to invest** before it goes up
  - **High valuation with no revenues, customer or IP**



## A few tips

- Never skip Due Diligence
- Do not invest if you do not understand
- Try to co-invest with experienced investors
- If it is too good to be true it probably is
- Keep in mind the future dilution
- Do a valuation with multiple scenarios
- Ask for regular KPI's (monthly)
- Negotiate terms if you can



# **Direct Investments**

Lessons from a bad investment

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# Bad investment (Part 1)

- Type of investment: Innovative high end luxury product

- Investment Story:

Invested 5 m CHF in equity as lead investor in the round  
Round C (last one before exit / sale to strategic investors)

Took board seat

Hired legal and operational auditors/experts for Due Diligence

Data Room available with lots of documentation

Negotiated a complex waterfall structure to protect investment

Negotiated specific terms of SHA and IA

- First Evolution:

6 months into investment the company is short of cash

None of the intended operational use of funds had been realized

Company on the verge of bankruptcy

Urgent re-financing needed

## Bad investment (Part 2)

- Discoveries from second Due Diligence by the investment team:

Managers paying themselves considerable salaries despite situation  
Important part of funding used to repay shareholder debts  
Management had little to no idea of market demand / situation  
No expense containment plan (marketing, sponsoring, staff, rent...)  
Important product quality issues not resolvable at POS  
Distribution network flooded with defective product  
Considerable parts / semi-finished inventory had been built up  
Significant capitalized R&D in balance sheet not amortized  
Massive negative impact on Cash-Flow for years to come

- Decision:

Take immediate corrective actions on costs and staff  
Reduce marketing expenses  
Downsize head-quarters  
Precise use of funds  
Further convertible of 3 m CHF to avoid bankruptcy in N+1



# Bad investment (Part 3)

- Final episode

Company went bankrupt 5 year later

It had never been able to recover from the initial errors

The sole cost of amortizing and cleaning the market from the initial defective products that had been overproduced amounted in multiples of investment

All investments were lost

- Red Flags that were missed:

**Absence of minutes from board meetings in Dataroom**

**Exit scenarios** too good to be true and no LOI

**No customer reference calls**

**No investor reference calls**

Operational implication of founders and **salaries paid**

**Management reference calls** (track record)

No real market analysis for the product and potential

Implication of **capitalized R&D expenses**

**Voting terms in SHA in favor of founders**

Setting monthly **KPI's**

No ERP in place

**Cash need** for a new brand promotion

**Multiple financing rounds** and shareholders (63 shareh. and 250 lines of financing)

**Board Member “hooked” by product**



# **Direct Investments**

## Due Diligence Checklist

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# Due Diligence Check List

1. **Company and Product Presentation**
2. **Statutory Documentation**
3. **Customers and Commercial Organization**
4. **Suppliers and Contractors**
5. **Organization and Human Resources**
6. **Logistics and Production**
7. **R&D, IP, Data Protection, Security**
8. **Financial Information**
9. **Business Plan and Current Financing**
10. **Environmental Impact**

# Due Diligence Check List

## 1. Company and Product Presentation

- ✓ History of the company and description of Business Model (Pitch Deck)
- ✓ Any recently prepared client presentation
- ✓ Product catalog / Brand awareness study
- ✓ Market Research
- ✓ Market Size assessment and positioning
- ✓ Competitive landscape



# Due Diligence Check List

## 2. Statutory Documentation

- ✓ Detailed organization chart
- ✓ Incorporation documentation
  - ✓ Shareholder Agreement
  - ✓ Investment Agreement
  - ✓ Bylaws
  - ✓ Board Regulations
  - ✓ Commercial Registrar and signature policy
  - ✓ **Signed Cap Table with financing history**
  - ✓ Subsidiaries documentation
  - ✓ Debt collection register
  - ✓ List of all legal claims past and pending
- ✓ **Signed Board and General Meetings minutes**

# Due Diligence Check List

## 3. Customers and Commercial organization

- ✓ Commercial / Sales / After-sales organization
- ✓ Commercial agreements (including SLA's)
- ✓ Customer contracts (including LOI's)
- ✓ **Reference call with customer**
- ✓ For each product or segment:
  - ✓ Year of launch
  - ✓ Price range
  - ✓ Sales and associated revenues per customer and geography
  - ✓ Analytical tracking: average basket, repeat-buyers, lead conversion metrics, sales cycle, churning, other specific KPI's.

# Due Diligence Check List

## 4. Suppliers and Subcontractors

- ✓ Main suppliers and subcontractors list
- ✓ Suppliers' contracts
- ✓ Intercompany agreements and transfer pricing
- ✓ **Reference call with supplier**
- ✓ Nature and duration of contracts
- ✓ Breakdown of purchases by area and type



# Due Diligence Check List

## 5. Organization and Human Resources

- ✓ Operational organization chart with managers and number of employees per department
- ✓ Evolution of the workforce and hiring plans
- ✓ Workforce distribution (Function, Age, Seniority, Status i.e. permanent, fixed term, temporary, ...)
- ✓ **Managers' CV's, salaries and work-related documents**
- ✓ ESOP
- ✓ Contracts of Key Persons

# Due Diligence Check List

## 6. Logistics and Production

- ✓ Description of the production chain
- ✓ Description of the logistics organization
- ✓ VCA (Value Chain Analysis)
- ✓ **In house vs. third party components**
- ✓ Contractual agreements
- ✓ Storage facilities
- ✓ **Inventory**
- ✓ Security and Quality certifications

# Due Diligence Check List

## 7. R&D, IP, Data Protection, Security

- ✓ R&D Organization and expense budget
- ✓ **Patents and Trademarks** applications and records
- ✓ FTO (Freedom to Operate) reports
- ✓ Domain name registration and ownership
- ✓ Data protection policy / GPDR compliance
- ✓ Key security measures / protocols and past issues



# Due Diligence Check List

## 8. Financial Information

- ✓ **Corporate and consolidated accounts**
- ✓ **Monthly cash flow monitoring and burn rate**
- ✓ **Management reporting and activity report (KPI's)**
- ✓ Financial projections (2-5 years)
- ✓ Bank accounts (Institutions and Balance)
- ✓ Insurance contracts
- ✓ **Loans and convertible loans agreements**
- ✓ Other contracts (Accounting, Audit, Rental, Leasing, Tax)

# Due Diligence Check List

## 9. Business Plan and Current Financing

- ✓ **Main assumptions used**
- ✓ Forecasted income and **cash flow statement**
- ✓ Investments and **CAPEX** planned
- ✓ Envisaged change in **Working Capital**
- ✓ **Use of funds** for the current exercise
- ✓ Forecasted **Cap Table with financing history**
- ✓ Proposed **Term Sheet and Financing Terms**

# Due Diligence Check List

## 10. Environmental Impact

- ✓ Positive impact
- ✓ Negative impact
- ✓ Impact framework
- ✓ Certifications
- ✓ Value Chain Analysis



# Contact Us

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